AGRICULTURAL FINANCE AND INSTITUTIONAL REFORMS IN BULGARIA

Lena Roussenova and Dimiter Nenkov
(Paper presented by Dr. Roussenova)

Abstract

Agriculture has traditionally played a significant role in the Bulgarian economy. Since 1997, the government has made rapid progress in implementing a wide-ranging reform program in agriculture, the financial sector and in the economy in general. The highest priority has been given to actions that result in a market-driven restructuring, rather than to financial support that would reproduce existing inefficient structures. The banking sector restructuring has been accompanied by the banks' cautious approach to lending in general and particularly to agriculture. Some sector-specific lending programs have been introduced but they could hardly make up for modest bank credit to agriculture. Most of these programs are continuously undergoing changes, consistent with the developments in the agricultural and banking sectors. With continuing recovery of public trust in banks, and with more than 70% of banks' assets owned or controlled by foreign private banks, the sector is expected to overcome conservative lending.

Introduction

Agriculture has traditionally played a significant role in the Bulgarian economy. Before the beginning of transition, Bulgaria was a major exporter of fresh and processed fruits and vegetables within the former Council for Mutual Economic Assistance (CMEA). The process of reforms and transition to market-based agriculture has been rather difficult for Bulgaria. Due to the disintegration of the traditional Bulgarian markets, specific procedures used to privatise state assets and restitute assets into private ownership, as well as due to the relative instability of the overall economy until 1997, there has been more disruption in the farming sector in Bulgaria than in many other Central and Eastern European countries. Since 1997, the government has made rapid progress in implementing a wide-ranging reform program with significant implications for agriculture and the financial sector. The highest priority has been given to actions that result in a market-driven sectoral restructuring, rather than to financial support that would reproduce existing inefficient structures. This approach has been expected to improve the sector's competitiveness and performance and thus contribute to maximising the benefit to the economy as a whole. The banking sector restructuring has been accompanied by the banks' conservative approach to lending in general and particularly to agriculture. Some sector-specific lending programs were introduced but they could hardly be considered substitutes for bank credit, as credit provided by them had not been sufficient to make up for modest bank credit to agriculture. Most of them are continuously undergoing changes, consistent with the developments in the agricultural and banking sectors.

1. The economic and agricultural situation in Bulgaria

1.1. Major economic developments

Following the 1996-97 banking sector and currency crises, the new Bulgarian Government implemented a radical economic reform program. Supported by the IMF, it introduced a currency board arrangement (CBA), which imposed prudent fiscal policies, tight prudential regulations, enhanced banking supervision, and radical economic restructuring. The implementation of the reform program resulted in improved macroeconomic fundamentals. Inflation and budget deficits have been put under control and the economy has experienced growth for a couple of years. The CBA introduction reduced inflation to about 1% in 1998. Some increase in inflation was recorded in 1999 (6.2%) and 2000 (11.4%) due to the strong US Dollar and high oil prices, but it is expected to subside to about 5% in 2001 (Table 1). Prudent fiscal policies have kept the budget deficit fairly low within the boundaries of 1-1.5%. In 2001 GDP growth is expected to be 5%, driven by private consumption and investment, as well as by productivity gains from structural reform.

Table 1. **Bulgaria: selected economic indicators**

	1996	1997	1998	1999	2000*	2001**
Real GDP	-10.9	-7	3,5	2.4	5.8	5.0
CPI, end of period	310.8	578.5	1.0	6.2	11.4	4.5
General Government balance/GDP, %	-10.4	-2. 5	1.0	-1.0	-1.0	-1.5
Current account balance/GDP, %	0.8	4.4	-0.5	-5.2	-5.8	-4.4

Source: BNB, NSI, MF, IMF.
*Preliminary, **Projections.

Since 1997 the reform program of the government has speeded up the pace of privatisation and as a result of it about 80% of the assets of commercial banks together with most of the former state-owned enterprises (SOE) have been privatised. A deeper and more substantial restructuring of the newly privatised enterprises remains to be completed in order to improve the efficiency and competitiveness of the economy. Weak financial intermediation and high level of annual external debt service[1] may constrain investment and economic growth. In the medium term, the risks include low growth owing to slow pace of reform, fiscal pressures on the expenditure side, and contagion from other CBA countries or emerging markets as Bulgaria moves toward reliance on market borrowing.

1.2. Significance and performance of agriculture

The significance of agriculture in Bulgaria has remained high when compared to other Central and Eastern European countries (CEEC). However, during the transition period the share of agriculture and forestry in GDP fluctuated widely: it more than doubled between 1993 and 1997

1. In 2001 total external debt service is expected to increase to USD 1.6 billion (10.8% of GDP) from USD 1.1 billion (9% of GDP) in 2000.

to about 24%, and then fell to about 13% in 2000 (Table 2). Agricultural employment in Bulgaria is high by European standards and has been growing continuously since the beginning of transition. In 1999 employment in agriculture reached close to 26% of total employment, cushioning to a certain extent the rising levels of unemployment in other sectors, particularly in industry. The rise in employment in agriculture together with the fluctuations in agriculture's share in GDP could be explained by different factors, including restructuring of the economy, de-capitalisation of agriculture, rise in subsistence farming, etc.

Table 2. **Share of agriculture in GDP and in total employment, 1991-2000**

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000* Q1-Q3
Share of agriculture in GDP, %	15.2	11.3	10.6	12.3	13.4	14.6	23.8	18.8	15.1	13.4
Share of agriculture in total employment, %	19.1	20.7	21.7	22.8	23.4	24.2	24.3	24.7	26	26.2

Source: NSI, 1999; European Commission, IMF.
*Preliminary.

Despite the increase in agriculture's share in GDP and employment, observed since 1992, the economic transformation resulted in a decline of agricultural production both in terms of output and yields of main products. The yields of the main crops (cereals, vegetables, tobacco) declined (with the exception of tobacco) during the 1990s by some 60%. Output of the major livestock products (meat, dairy and eggs) declined even more than crop production. The relative importance of crop and livestock production has been changing continuously, but in general, the crop sector has preserved its dominance.

In 1991 prices of agricultural inputs were liberalised while output price increases were restricted until 1997, when almost all price and trade restrictions were eliminated. The price-cost squeeze until 1997 was more severe and lasted longer in Bulgaria than in other CEEC. It penalised agricultural producers and resulted in a decline in output and a limited use of fertilisers and agro-chemicals.

The fall in agricultural production has been caused by a number of supply-side factors: reduction in subsidies for fertilisers, decline in mechanisation, reduction in the herd, resulting from privatisation of animals by ill-equipped farmers, etc. In addition, declines in both domestic and external demand for agricultural products magnified the adverse effects of the domestically generated supply-side disruptions:

- decline in per-capita consumption of meat and other major agricultural products due to significant decline in the purchasing power of the population;

- decline in external demand by traditional importers of Bulgarian agricultural produce, as the CMEA and the Former Soviet Union (FSU) disintegrated.

Despite these developments, together with Hungary, Bulgaria continues to be the only CEEC that has a positive balance of food and agricultural trade.

In addition to the decline in demand for agricultural products, the fall in production in the transition period could be attributed to general disruptions linked to the implementation of the land reform, as well as to insufficient investment in agriculture and food processing. Investment in rural infrastructure has declined sharply over the last decade. The level of support to agriculture, as measured by the OECD methodology indicates that since 1997 Bulgarian agriculture has been operating in a fairly neutral policy environment[2] (OECD, AGR/CA/APM(2000)15). In addition, as explained by section 2., bank credit for agricultural producers has been insufficient. The provision of subsidised credit through different programs has been a part of the overall agricultural policy framework but has not been enough to make up for limited access to bank credit.

1.3. Reforms in agriculture

The transformation of agriculture in Bulgaria was based on the principles of ownership of land and other agricultural property. The aim of the reform program was to create a market-oriented and internationally competitive agricultural sector. In 1991 the Law for Agricultural Land Ownership and Land Use launched the restitution of land ownership rights. The Law was designed on the basis of historic justice, and efficiency objectives were not considered a priority. As a result of land reform 98% of agricultural land is privately owned and the remaining 2% is under legal dispute. Forest ownership restitution is underway and is close to completion.

The first stage of restructuring and restitution of agriculture has already been completed, and the next stage of consolidation of farm ownership has just begun. The process of land restitution has resulted in highly fragmented land ownership. However, the land-use pattern is less fragmented, because producer co-operatives and formal and informal leasing arrangements have resulted in the establishment of larger farms. Within the emerging farm structure there are both large farms (private co-operatives and private individual farms), and a large number of small-scale farms. The future viability of the small-scale agricultural producers is questionable but they still play an important role as self-sufficient units.

The legal framework for the functioning of a land market has been completed but an active agricultural land market has not developed yet. A Cadastre and Property Register Law was adopted by Parliament in 2000, which allows for the creation and administration of a unified cadastre and property register. A Cadastre Agency was created at the Ministry of Regional Development and Public Works. Additional efforts need to be made to create a complete unified cadastre as well as to make the administrative structures operational. The Ministry of Agriculture and Forestry (MAF) created a land market information system in end-1999. The adoption of legislation and creation of administrative structures are only the first steps to the creation of a functioning and transparent land market. However, the lease/rental market has developed quite successfully and is currently playing an important role in the emergence of private farms. Some of the main obstacles, hindering the development of the land market are: low profitability of the sector, high transaction costs, difficulties in finding collateral and obtaining credit, etc. The development of a true land market will facilitate the acceptance of land as collateral by banks.

2.. Support to agriculture, as measured through Total Support Estimate (TSE), was slightly negative in 1999, reflecting the relatively small budgetary transfers to producers and transfers to general services, as well as the low market support. At minus 0.1% the percentage TSE (% of GDP) was lower than the average for transition economies, OECD and EU (OECD, AGR/CA/APM (2000)15).

2. Banking sector reform and performance

Compared to most other CEEC, the Government of Bulgaria has very limited intervention programs in agriculture and agricultural finance. The main way of Government intervention is the subsidised credit program of the State Fund *Agriculture* (SFA), which has commercial banks as its agents. Apart from SFA credit and lending under some other smaller programs (see Section 3), agriculture relies mainly on commercial bank credit as any other sector. The banking sector performance is of major importance for agricultural finance, as it determines to a great extent the amount of credit available to agriculture, as well as the terms under which it can be extended.

The Bulgarian banking sector has been undergoing significant institutional reforms since the 1996-97 banking sector crisis. The new Law on the Bulgarian National Bank (BNB) introduced the CBA in mid-1997, which represented a major change in the Bulgarian monetary regime. The CBA introduced only a limited lender of last resort (LOLR) facility and required new stricter prudential regulations. Foreign exchange reserves in excess of what is needed to cover the monetary base provide a limited LOLR facility in case of liquidity risks, affecting the stability of the banking system[3]. These funds are kept as a deposit of Banking Department with Issue Department, and bank refinancing is limited by the size of the deposit, which is also subject to negotiations with the IMF. One of the performance criteria of the IMF-supported program under the current Extended Fund Facility requires consultations with the IMF when a loan above BGN[4] 2 million is to be extended to a bank.

The CBA introduction speeded up bank privatisation. The majority of state-owned banks has already been privatised by foreign investors. At present more than 80% of banks' assets are privately owned and more than 70% of banks' assets are held or controlled by foreign banks. As of October 2000, publicly owned banks (State Savings Bank, Biochim, Promotional Bank and Municipal Bank) held 18.8% of the total banking sector assets. By end-2001, the Government intends to sell Biochim and State Savings Bank.

The CBA introduction together with the new Law on Banks (1997) required the introduction of new much tighter prudential regulations. For example, risk weighted capital adequacy requirements were raised initially to 10% and subsequently to 12%. The minimum required reserves were kept at a relatively high level. Initially, BNB Regulation 21 fixed them at 11% of deposits, while in mid-2000 they were reduced to 8%. The conditions for access to the minimum required reserves were eased by the new version of Regulation 21 in early April 1998, which introduced daily averaging, and allowed banks access to 100% of required reserves on any given day. Tightening of prudential regulations included new requirements on large loan exposures, aggregate exposure to a single party, open foreign exchange position, etc. In addition, the government introduced stricter policies for providing government guarantees for loans.

3. Regulation 6 of the BNB establishes the terms of extending collateralised Lev loans to banks in cases of liquidity risks affecting the stability of the banking system. The total amount of the highly liquid assets pledged as a collateral should cover at least 125% of the loan amount approved by the BNB. The loan should be repaid within three months.

4. BGN = BGL 1 000 since mid-1999.

Table 3. **Quality of loan portfolio of commercial banks**

	Dec-97	Dec-98	Dec-99	Dec-00
Loans (million, BGN)	3 806	5 945.9	5 042	7 395
Standard, %	78.8	86.6	86.2	91.8
Watch, %	3.7	3.6	4.4	2.8
Substandard, %	2.7	1.9	1.4	1.2
Doubtful, %	2.0	0.6	0.9	0.8
Loss, %	12.9	7.3	13.1	3.4
Provisions, %			10.0	6.5

Source: BNB.

Both on-site and off-site banking supervision have been enhanced since 1997, which has contributed to improved compliance with prudential regulations. Since the adoption of the new banking law and related prudential regulations, the incidence of violations of major requirements, such as capital adequacy, open foreign exchange position and loan concentration to individual borrowers, has been reduced significantly. Total risk-weighted capital adequacy increased from 10.2% in June 1997 to 35.6% in December 2000. The quality of banks' loan portfolios kept improving, with standard loans representing close to 92% of all loans at the end of 2000 (Table 3.). For comparison, non-performing loans represented more than 70% of loans in the pre-crisis 1995. Tighter prudential regulations and enhanced banking supervision required from banks more conservative lending policies, which placed challenges to intermediation but resulted in a generally sounder banking sector.

Table 4. **Domestic credit**

	Dec-95	Dec-96	Dec-97	Dec-98	Dec-99	Dec-00
Domestic credit/GDP, %, including:	67.4	61.5	28.8	20.7	19.0	18.2
Claims on general govt., %	30.6	47.0	11.4	4.3	2.0	2.1
Claims on non-financial public sector, %	19.2	30.1	6.5	4.8	3.5	1.6
Claims on private sector, %	21.6	37.0	11.0	11.6	13.5	14.7

Source: BNB.

Although the banking sector is sound, the monetary aggregates and deposit-to-GDP indicators suggest that the public's trust in banks is growing but has not been fully restored to its pre-crisis level yet. Once the CBA was introduced, initial re-monetisation began to speed up without being able to reach the pre-crisis levels except for the Lev currency. At the end of 2000, monetisation, measured by broad money (M3) as a percentage of GDP, marked some progress, but at 36% in end-2000 it is still below the end-1995 level. Deposits-to-GDP ratio remains stable at about 21% throughout the post-crisis period but is also below the pre-crisis level, as the revival of confidence in banks since the CBA introduction has not been strong enough to restore deposits to their pre-crisis level. The banking sector crisis affected depositors' preference and shortened the maturity structure of deposits, making demand deposits the preferred ones, which puts certain limitations on banks' long-term lending.

Banks prefer to invest in low-risk government securities and deposits with foreign banks. At the end of 2000 banks' loans represent only 31% of banks' assets, while more than 50% of banks' assets are invested in securities and deposits with banks, mainly foreign. Domestic credit-to-GDP ratio and all its components marked a substantial contraction from 67% in end-1995 to 18% in end-2000 (Table 4). Since the second half of 1997 credit to the central government has begun to decline due to improved fiscal discipline and lower interest payments on domestic debt. Credit to the private sector has been growing both in absolute terms, and as a share of domestic credit (close to 80%) but as a percentage of GDP is still low at 14.7% in end-2000. The modest deposit base and credit to the private sector limit the potential contribution of banks to economic development in general and to agriculture in particular.

The relatively slow growth of credit to the private sector as compared to the private sector growth is usually explained by banks' risk aversion related to the slow recovery of public trust in the post-crisis period, the CBA limited LOLR facility, and new tighter prudential regulations. In addition, there are some other important factors behind banks' behaviour (Ulgenerk, Esen and L. Zlaoui, 2000):

– Economic restructuring of both the real and financial sectors makes banks increasingly risk averse. Banks that have been undergoing privatisation have become conservative in order to avoid portfolio deterioration right before their privatisation. At the same time some of their traditional customers have ceased to exist or reduced operations, while new customers from the emerging private sector do not have a credit history or appropriate collateral. Intensification of industrial restructuring, accompanied by substantial firm exit and new entry has created uncertain customer base that makes banks increasingly conservative in lending.

– Insufficient competition in the banking sector also impedes lending. Interest spreads are high and banks have not felt pressure to cut costs and diversify their products yet.

– The imperfect legal environment and uncertain protection of creditors' rights also contribute to banks reluctance to increase lending. The resolution of financial disputes is often slow, and contract enforcement weak, collateral is hard to seize, and bankruptcy and liquidation procedures remain clumsy and uncertain.

Banks' cautious attitude to lending affected seriously agriculture. In the end of 2000 bank credit to agriculture, including SFA credit amounted to less than 1% of GDP. In addition to all factors determining banks' lending policies, there are some sector-specific factors, such as absence of collateral, low profitability and higher uncertainty, contributing to even more limited lending to agriculture (See ATTACHMENTS 1 and 2). Banks demand higher collateral for loans to farmers both due to stringent prudential regulations, and because they view agriculture as a risky sector, in which they do not have enough expertise and can hardly assess risk. On the other hand, farmers continue to be reluctant to mortgage their homes, which are the only collateral banks consider acceptable. Land cannot be accepted as a collateral, because a true land market has not been developed yet.

Some specific measures, such as use of warehouse receipts as collateral for bank loans for working capital, have already been introduced but remain insufficient to increase lending to agriculture[5]. Additional policy measures are expected to be implemented soon and to boost credit

5. The use of warehouse receipts is still limited due to the underdeveloped trade with grain on the Commodity Exchange. Other obstacles include the limited capacity of licensed warehouses, insufficient

to agriculture. Among them are improvements of the legislative framework for equipment and machinery leasing, as well as creation of functioning registers to which potential lenders can refer to check whether the collateral has already been used on another loan. In order to strengthen creditors' rights, improvement of collection of collateral, and a new bank bankruptcy law to deal with closed banks, are underway.

With continuing recovery of public trust in banks, and with more than 70% of banks' assets owned or controlled by foreign private banks, competition in the sector is growing and banks are gradually overcoming their conservative lending policies. In order to make up for insufficient lending to agriculture by commercial banks, several specific lending schemes were introduced in the mid-90s. However, they cannot be considered substitutes for bank credit.

3. Programs supporting lending to agriculture

Apart from commercial bank credit, agriculture currently relies on specific lending programs, based on the SFA and *Tobacco* Fund. Other institutions, providing lending to agriculture are the Private Mutual Rural Credit Associations. There are internationally supported programs such as SAPARD, as well as bilateral programs that provide either loans or grants, to agriculture. All these lending programs are continuously undergoing changes, reflecting the developments in agriculture and banks.

3.1. Tobacco Fund and State Fund Agriculture

There are two major funds, set up to provide credit to agriculture within specific programs. These are the *Tobacco* Fund and the SFA. Fund *Tobacco* lends funds to tobacco processors only for the tobacco, which has been produced under a contract, but has not been purchased[6], while SFA provides loans to support regular farming activities. The SFA was established in 1995 on the basis of the Law on Support of Agricultural Producers and began operating in early 1996. The SFA is a legal entity, which has its own budget, subject to annual approval by the Council of Ministers of the Republic of Bulgaria upon a proposal of the Minister of Agriculture and Forestry. The SFA main activity has been to provide funds directly to farmers, using commercial banks as agents. The different types of schemes financed by the SFA vary from year to year, and include a seasonal credit facility[7], short-term credit[8], long-term investment credit[9] and subsidies[10].

The SFA extends its short-term loans under specific regulations and requirements. The transaction costs involved in the administration of the SFA scheme are somewhat distortive as

---

capitalization of the fund that guarantees the loans extended against warehouse receipts, and insufficient protection of creditors' rights.

6. In July 2000 the Council of Ministers issued Ordinance No. 511, according to which, Fund *Tobacco* could lend to tobacco processors for unsold quantities of contracted tobacco, produced in 1999, which had not been purchased by April 2000. Under a decision of the Board of Directors, Fund *Tobacco* extended BGN 1.311 million loans to tobacco processors for purchasing 634 tonnes of tobacco, from tobacco harvest 1999.

7. Usually finances inputs for wheat, maize and sunflower production with a 50% interest subsidy.

8. In 2000 the SFA earmarked short-term credit of about BGN 34.5 million, out of which close to BGN 30.0 million (close to 87%) was disbursed.

9. In the first half of 2000 about BGN 40.0 million was allocated for investment projects but only part of it has been disbursed.

10. The SFA has disbursed subsidies of about BGN 10.3 million.

they favour certain groups of farmers and certain crops over others. Specific regulations provide incentives to farmers to change their production activities in a way that is not in line with improving the sector's overall net income contribution. The SFA short-term credit lines compete to a certain extent with potential credit lines of commercial banks. Banks might generally be more interested in short-term lending, as it is relatively less risky than long-term credit in unknown markets and for unknown clients. Though competition with the SFA subsidised credits could hardly be considered the major cause for banks' conservative lending policies, it might well contribute to them. Recognising these problems, the Government intends to gradually phase out SFA short-term credit lines.

In addition to the short-term credits, the SFA has also a number of longer-term investment credit lines that provide access to long-term credit to farmers, which is difficult to obtain from banks, since banks are constraint by their short-term deposit base and make very few long-term loans. However, even the SFA investment credit lines are hardly made use of, because banks are reluctant to make what they consider relatively small high–risk loans for low interest rates on them. To overcome banks' unwillingness to make use of the SFA's investment credit lines, the SFA might wish to shift emphasis from direct long-term credit to providing partial risk guarantees for these credit lines. This approach creates incentives for banks to carry out a more careful risk assessment for each loan, as they will bear most of the risk of default. Banks, not the SFA should be given the opportunity to determine the procedures and risk assessment of investment projects, supported by the SFA.

Some important steps have been undertaken to reform the SFA's investment program, including requirements for annual repayments of at least principal, rather than lengthy grace periods, so that the adverse effect on the credit market is minimised. Nevertheless, the Government is to develop a strategy to promote alternative private bank facilities, such as equipment leasing, mortgage loans, etc.

The SFA investment program is undergoing reform. Currently the MAF has decided to make the SFA an agent for SAPARD in order to make use of its institutional capacity to provide technical assistance in project assessment. According to the agreement achieved with the European Commission (EC) the functions of a SAPARD Agency for Bulgaria will be performed by a functional structure set up within the State Fund Agriculture. Applicants for grants under SAPARD are expected to apply at the SFA Regional Directorates, which are supposed to review and assess applicants' documentation as well as to make on-site inspections of applicants. The SFA Regional Directorates have to approve or reject applicants for SAPARD co-financing within a period of three months.

The State Fund Agriculture launched the accreditation program in July 1999. The process of establishing the administrative structure of the Agency, staff recruitment, elaboration of manuals and other necessary documentation defining the rules of procedure of the operational, paying and auditing unit of the Agency, has already been completed.

3.2. SAPARD

The European Union (EU) created SAPARD with the objective to support and prepare applicant countries in the field of agriculture during the period 2000-2006 through providing annual subsidies of about Euro 53 million to co-finance different projects. The adoption of a National Agriculture and Rural Development Plan (NARDP) is a precondition for launching the EC program for agriculture and rural development. The NARDP[11] was prepared by the MAF in compliance with the main objectives of the National Economic Development Plan and covers the period 2000-2006. The NARDP was drafted in close collaboration with representatives of regional and local authorities, farmers' associations, regional development agencies and other non-governmental organisations. The two main objectives of NARDP are:

- "development of an efficient, sustainable and competitive agriculture and food-processing, through improved market and technological infrastructure, as well as strategic investment policies aimed at reaching EU standards;
- achievement of sustainable rural development, consistent with the best environmental practices through creating alternative employment and appropriate infrastructure, diversification of economic activities, leading to improved living conditions, higher income and better employment opportunities for the rural population."

For the purpose of achieving these two objectives four priority areas for Bulgarian agriculture were defined:

(1) improvement of the conditions for production, processing and marketing of agriculture, forestry and fishery products in accordance with EU standards; development of environmentally friendly agriculture, as well as improvement of the activities for environmental protection in agriculture and forestry;

(2) integrated development of rural regions aiming at preservation and consolidation of their economies and communities in order to cut down the depopulation process in these regions;

(3) investment in human resources – qualification and training of employed in the production and processing of agriculture, forestry and fishery products;

(4) technical assistance.

The above **4 priority areas** determine more than 10 measures, which are in the focus of the investment projects, financed by the EU under SAPARD. Priority area (1), for example, includes 6 measures - 1.1 to 1.6. Measure 1.1 – *Investments in agriculture farms*, is for supporting private investments for the improvement of technologies and quality of production in the major agriculture sectors.[12] Measure 1.1.includes 4 sub-measures (supports 4 sectors), which are shown in ***Table 5*** below.

11. The NARDP was adopted by the Council of Ministers by a Decision No. 726 dated 22 Nov. 1999 and presented to the EC. In October 2000, NARDP 2000-2006 was approved by the European Commission.

12. Measure 1.1 is quite representative for the conditions of supporting investment projects of farmers under SAPARD and for the purpose of this report we will present in more detail the characteristics of SAPARD support for this measure only.

Table 5. **SAPARD, Measure 1.1: investments in agriculture farms in Bulgaria - Budget allocation by sectors**

Sector	Allocated, %
Milk and milk processing	23.28
Meat and meat processing	8.96
Fruit-growing and vine-growing	51.60
Vegetable-growing, ethereal plants, herbs, corn/wheat growing, oil plants, cotton, tobacco (high-quality brands)	16.16
Total	100.00

SAPARD financing under measure 1.1.can be summarised as follows:

Potential beneficiaries

Beneficiaries may be private agricultural producers – natural/physical persons or legal entities, both have to be registered as agriculture producers. The legal entities with more than 25% of state-owned shares are not eligible.

Financing conditions

Financing is in the form of subsidies. The total amount of the subsidy (national funds + EU funds) is 50% of the approved investment costs. The amount of the subsidy is calculated by deducting aids/funds received from other public donors. The financial contribution of the beneficiary shall be 50% of the approved investment costs.

The maximum amount of the funds to cover 50% of the approved costs of investment projects is Euro 500 000 per farm for the period of program implementation (2000 – 2006). The minimum amount of the funds to cover 50% of the approved costs of investment projects for the period of program implementation is:

- Euro 15 000 for the first two sectors in ***Table 5*** – milk and meat;
- Euro 10 000 for the third and fourth sectors in ***Table 5*** – orchards, vineyards, vegetables, tobacco, etc.

Investment costs may include project preparation costs up to 5% of total investment costs, and up to 12% in the cases of development of detailed design for construction.

General eligibility criteria (applicable for all 4 sectors)

- young farmers – age between 18 and 40 years[13];
- full employment;
- at least 50% of total income of the beneficiary comes from the farm;

13. Currently less than 15% of the farmers in Bulgaria are under 40 years of age.

- at least three years of experience in agriculture or a diploma for acquired qualification in the field of agriculture, issued by a reputable/acknowledged school;

- less than 50 employees in the farm[14];

- the investment project is for protection of the environment;

- the investment project is for improvement of the hygienic conditions of production.

SAPARD is expected to begin financing the following projects, included in three of the four priority areas: investments in agricultural farms, processing and marketing improvement of agricultural and fish products, development and diversification of economic activities, setting up producer groups, and provision of technical assistance.

The SAPARD Agency was accredited in December 2000 by the Bulgarian Government and in May 2001 by the European Commission. The SAPARD Agency is responsible for project selection, tendering and contracting, execution of on-site inspections both prior to and after project approval, monitoring of progress of measures against indicators, reporting on progress against indicators, authorization of payment, execution of payment, setting up a reliable programme implementation database, etc.

3.3. Agricultural Capital Fund Scheme (ACFS)

Small farmers will continue to constitute a substantial part of the rural sector for some time, though their number is expected to dwindle as land consolidation proceeds. However, their access to commercial bank credit remains quite limited and they definitely need some assistance in obtaining loans. The Private Mutual Rural Credit Associations (PMRCAs) represent another program that provides easier access to credit for small-scale farmers.

The PRMCAs' operation is made possible by paragraph 17 of the Transitional and Final Provisions to the Law on Banks, which authorises them to undertake lending activities, without being licensed as banks. The General Implementation Rules of the ACFS and the standard Organisation Statute appended to the Memorandum of Understanding determine the scope of the PRMCAs' operations. The PRMCAs may benefit from some improvements in the legislative framework, treating their operation.

The PMRCAs operate under the ACFS, which is financed by PHARE and the Government of Bulgaria. Under the Memorandum of Understanding, between the Government of Bulgaria (GOB) and the European Commission (EC), both parties agreed to co-fund the project. The EC granted ECU 7 million and the GOB provided the Leva equivalent of ECU 3 million. These funds were used to increase PMRCA capital and to extend loans. In 1998, the GOB provided to ACFS another BGN 4 million equivalent through the SFA. In February 2000, the Federation of the PMRCAs entered into a partnership with the German Co-operative and Raiffeisen Union. It committed itself to providing technical and consulting assistance to PMRCAs under the project *Bulgarian Co-operative System Facilitation* financed by the German government.

As of end-1999, PRMCAs extended 5 500 loans of total value of BGN 15 million. The repayment rate was estimated at 93%. One-year loans of value BGN 3 000 represent the

14. Prevailing is the number of small and medium private farms in Bulgaria. Only 0.2% of them have more than 10 ha of land. The average amount of arable land for private farms is between 1.5 ha and 2 ha.

prevailing number of loans extended under the PRMCAs. However, there have been a number of investment loans of value up to BGN 30 000 maturing in 3 years.

3.4. *Experience of the Swiss Co-operation with Bulgaria in the field of agriculture development*

The Swiss Co-operation Program with Bulgaria has grown substantially within the last four years, and has developed two specific projects, providing finance for agriculture. The **Swiss Agency for Co-operation and Development (SDC)** is in charge of the Technical Assistance including about 20 projects/programs in various sectors. Two of the projects/activities of the Swiss Co-operation Program, related to the sector of agriculture, are (i) Development of Sustainable Agriculture in the Region of Central Balkan Range and (ii) Credit Commission.

(i) Development of Sustainable Agriculture in the Region of the Central Balkan Range

The project is managed by the Swiss Foundation for Sustainable Agriculture in Bulgaria (Foundation), which was set up in 1998 by the Research Institute for Biological Cultivation (FiBL), Frick, Switzerland. The project promotes an effective use of resources that can help farmers meet the demands of the market in the best possible way. The aim is to promote farming efficiency by acquiring more information and applying the methods of sustainable bio-agriculture. The target group are independent, capable and market oriented farmers from eight municipalities in the Central Balkan area. The project foresees the following measures: (1) development of a concept for an environmentally friendly use of resources; (2) dissemination of ecological production methods (use of fertilisers, cultivation of pasture, harvest rotation, etc.) through information, specialised publications, training, demonstrations in the farms, consulting by Swiss and Bulgarian experts; (3) extension of investment loans that will increase production capacities and (4) support for the regional marketing of farm produce through market research and marketing strategies. One of the consultants' main activities is to assist farmers in drafting business plans for applying for loans.

(ii) Credit Commission

At the end of 1999 the United Bulgarian Bank (UBB) and the Swiss Agency for Development and Co-operation (SDC) signed an agreement for opening a credit line to support private farmers and independent small and medium enterprises (SME) from the mountain regions of the Central Balkan Range – the Region of activity of SDC's projects for promoting sustainable agriculture (FiBL) and assisting SME's (FAEL). A Credit Commission responsible for the lending procedures has been set up within the framework of the Co-ordination Office of the SDC in Sofia, which makes the final decisions on extending loans.

Credit line for private farmers (investment credits)

The size of the credit line is 500 000 CHF for the first three years of the projects. The maximum loan is up to the Leva equivalent of 15 000 CHF. Financing is provided for up to 70% of the total project cost. The term of repayment is up to 3 years with a possibility for a grace period of 6 months and an interest rate of about 10-11% (the base interest rate + 7). Entitled to credits are only producers from the target region that are market oriented and applying the method of organic (bio-) farming.

The loans are extended to the farmers by UBB. Farmers-loan recipients usually use buildings, equipment, livestock, etc. as collateral. The amount of collateral, required by the credit commission varies depending on the type of assets and their liquidity but rarely the estimated market price of assets used as collateral exceeds 110-120% of the loan amount. This is quite preferential for the farmers, provided that the collateral for investment loans, required by commercial banks is normally much higher.

Some major specific requirements (eligibility criteria) for providing loans from the Swiss credit line include: (1) The farmer applies the methods of biological agriculture, (2) Age – under 50 years, (3) The farmer is registered as an agriculture producer (4) Agriculture accounting is introduced and strictly applied after the loan is extended, (6) Co-operation with the Swiss Foundation for Sustainable Agriculture in Bulgaria, (7) The farmer has the necessary land on the territory of the investment project, either owned or rented, (8) At least 50% of the production is for the market, (9) At least two years experience in agriculture / farm management.

The SDC credit line for farmers is a small-scale one, and it has not been set up solely for the purpose of providing loans to farmers. The project aims at improving the capacity of farmers to apply for bank loans, and bank staff to review and appraise loan applications from the agriculture sector. One of the major objectives is to test mechanisms for encouraging and promoting the involvement of commercial banks in providing loans to private farmers on a much broader scale.

The loan applications are reviewed, analysed and appraised independently by both the Foundation and the staff of the respective regional branches of UBB. Most of the work on drafting loan applications, including business plans, is done by the responsible Foundation team, who acts as the main consultant to the farmers in this process. After that loan applications are submitted to the Credit Commission, which makes the final decisions on financing. The Credit Commission includes representatives of SDC, the Foundation and UBB, as well as independent experts.

One major reason for banks to refrain from providing loans to farmers is that their lending departments are not familiar in detail with the specifics of agriculture business. The joint work of the Foundation, the Credit Commission and UBB has indicated that at this stage, loan officers of Bulgarian banks are not enough prepared for appraising farmers' loan applications. In this respect the program of the Credit Commission envisages training of banks' loan officers in Switzerland in developing and adapting methodology / guidelines for review, analysis and appraisal of farmers' credit files.

4. Conclusions

The first stage of restructuring and restitution of agriculture has already been completed, and the next stage of consolidation of farm ownership has just begun. Although the legal framework for the functioning of a land market has been completed, an active agricultural land market does not exist yet. Economic transformation resulted in a decline of agricultural production both in terms of output and yields of main products. The decline in production could be attributed to general disruptions linked to the implementation of the land reform, insufficient investment in agriculture, and decline in external demand by traditional importers of Bulgarian agricultural produce. Availability of investment capital continues to be a constraint on the ability of agricultural and agro-industrial producers to restructure, improve their competitiveness and grow. Bulgaria has limited intervention programs in agriculture and agricultural finance. The level of support to agriculture, as measured by the OECD methodology indicates that since 1997 Bulgarian agriculture has been operating in a fairly neutral policy environment. In addition, bank credit for agricultural producers has been insufficient.

Agriculture relies mainly on commercial bank credit as any other sector, which makes the banking sector performance of major importance for agricultural finance. The Bulgarian banking sector has been undergoing a significant institutional reform since the CBA introduction in mid-1997, which represented a major change in the monetary regime, and imposed new conditions of operation on the banking sector. It provides only a limited LOLR facility and together with the new Law on Banks required the introduction of new much tighter prudential regulations. Banks' cautious approach to lending has placed challenges for intermediation but has resulted in a generally sounder banking sector.

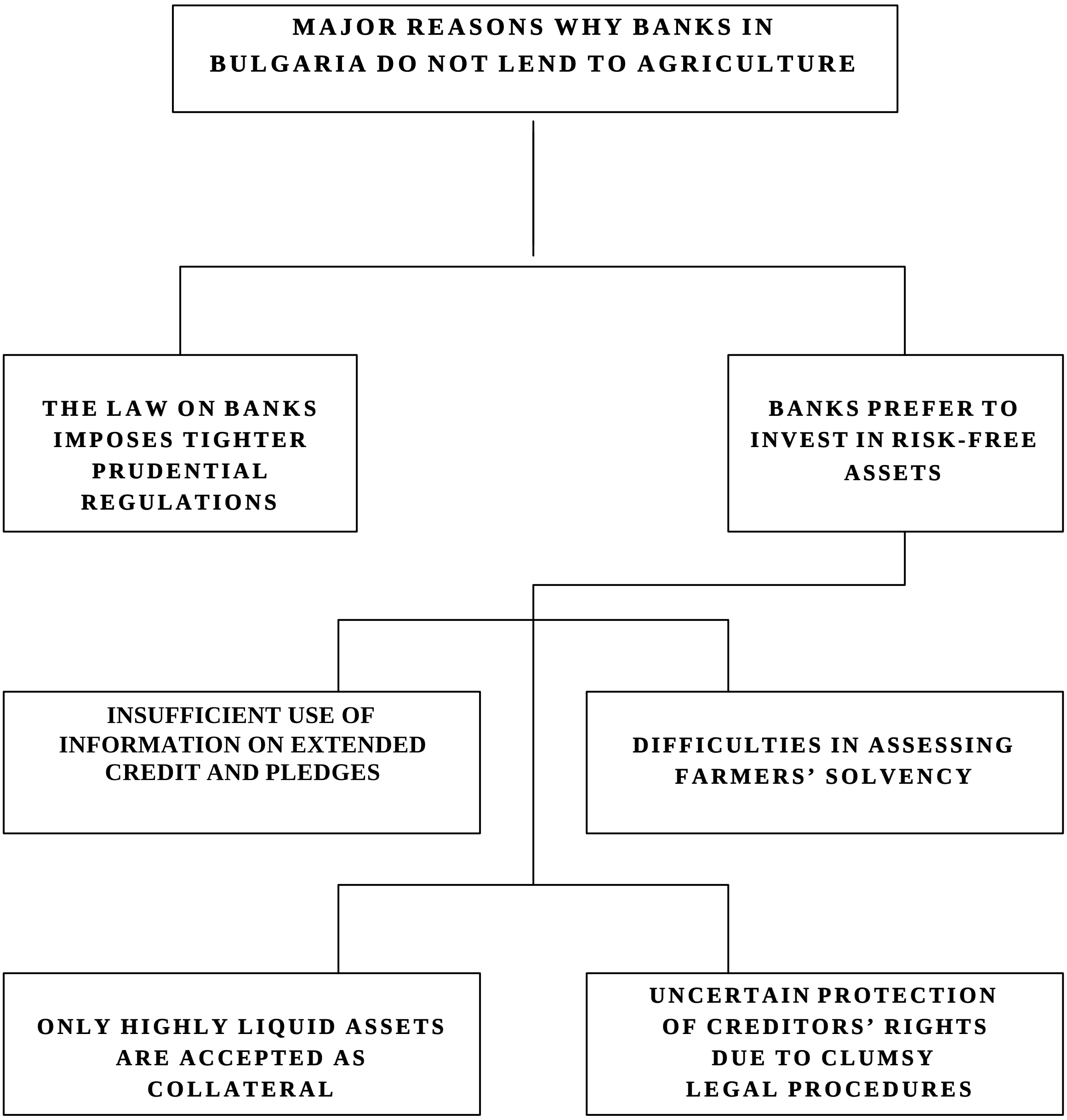
In addition to all factors determining banks' conservative lending policies, there are some sector-specific factors, such as absence of collateral, low profitability and higher uncertainty, contributing to even more limited lending to agriculture. Banks demand higher collateral for loans to farmers both because of the stringent prudential regulations, and because they view agriculture as a risky sector, in which they do not have enough expertise and can hardly assess risk. On the other hand, farmers continue to be reluctant to mortgage their homes, which are the only appropriate collateral banks consider acceptable. Land cannot be accepted as a collateral, because a true land market has not been developed yet.

Some sector-specific measures, such as use of warehouse receipts as collateral for bank loans for working capital, have already been introduced. Additional policy measures will be implemented to boost credit to agriculture. Among them are improvements of the legislative framework for equipment and machinery leasing, as well as improvement of the functioning registers to which potential lenders can refer to check whether the collateral has already been used on another loan. In order to strengthen creditors' rights, improvement of collection of collateral, and a new bank bankruptcy law to deal with closed banks, are underway. With continuing recovery of public's trust in banks, and with more than 70% of banks' assets owned or controlled by foreign private banks, competition in the sector is growing and stimulating banks to overcome their conservative lending policies.

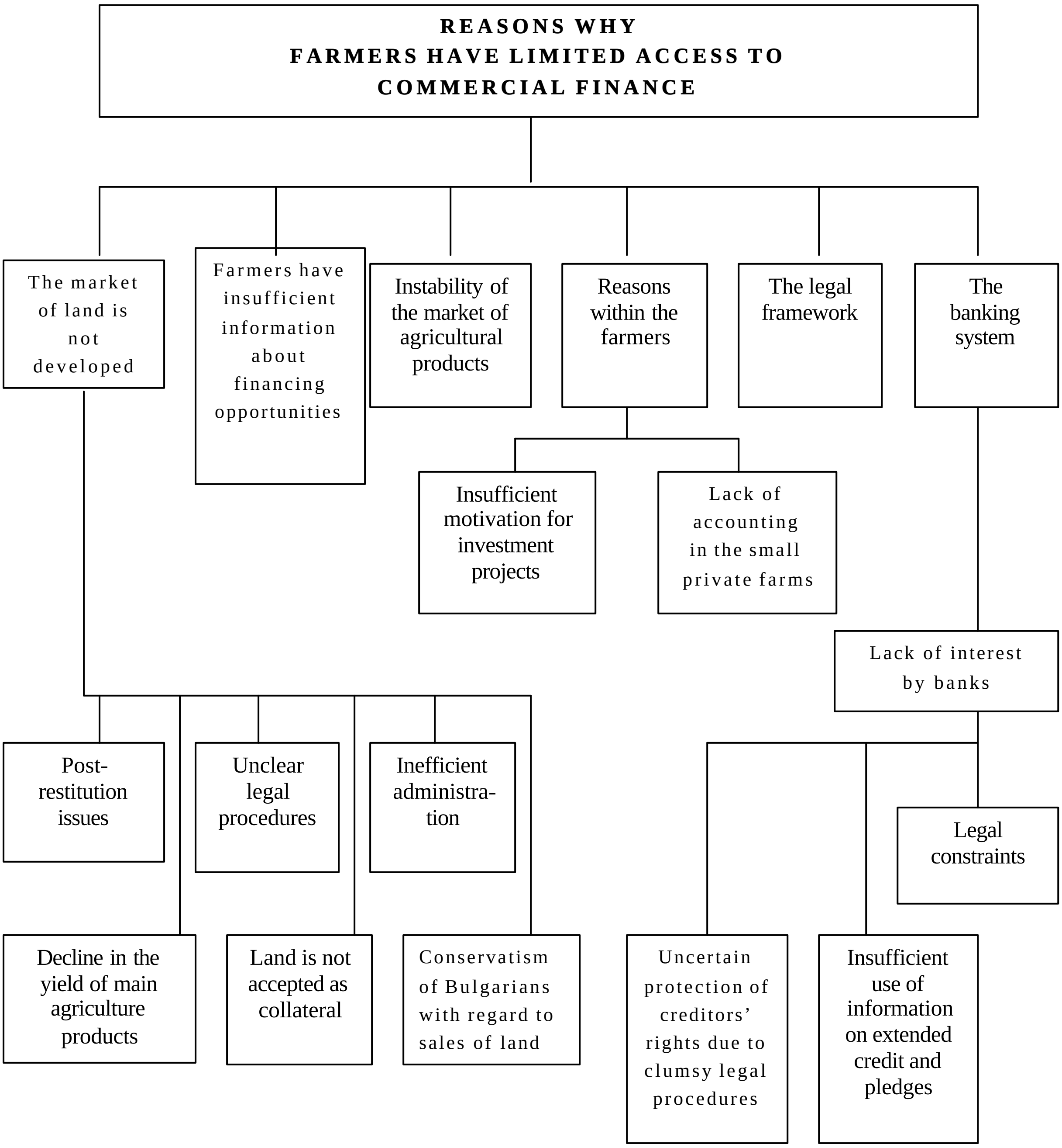
Apart from commercial bank credit, agriculture currently relies on specific lending programs, based on the SFA and *Tobacco* Fund. Other institutions, providing lending to agriculture are the Private Mutual Rural Credit Associations. There are internationally supported programs such as SAPARD, as well as bilateral programs that provide or will soon begin providing either loans or grants, to agriculture. The existing programs that support lending to agriculture cannot be considered substitutes for bank credit, as credit provided by them cannot make up for bank lending. Most of these programs rely on commercial banks as their intermediaries. However, they have failed to address seriously the issues of lack of sufficient incentives for banks to provide finance to agriculture. This has been one of the main deficiencies of the SFA operation, which should not be repeated under new programs, including SAPARD.

The programs supporting lending to agriculture are continuously undergoing changes. For example, the SFA investment program has undergone reform. The MAF decided to make the SFA an Agency for SAPARD in order to make use of its institutional capacity to provide technical assistance in project assessment. The SAPARD Agency was accredited in December 2000 by the Bulgarian Government and in May 2001 by the European Commission. SAPARD is going to play a major role in preparing Bulgarian agriculture for EU accession. The EU created SAPARD with the objective to support and prepare applicant countries in the field of agriculture during the period 2000-2006. The adoption of a National Agriculture and Rural Development Plan, which Bulgaria has already done, is a precondition for launching the EC program for agriculture and rural development.

ATTACHMENT 1



ATTACHMENT 2



BIBLIOGRAPHY

Agrosvjat-Biblioteka (2000),
The Money for Your Business, Sofia.

Bulgarian National Bank (2000),
Information Bulletins, 2000.

Bulgarian National Bank (1999),
Annual Report, 1999.

Commission on Bulgaria's Progress Towards Accession (2000),
Regular Report, November 2000.

Credit Commission at the Co-ordination Office of the Swiss Embassy,
Internal Rules and Procedures for the Work of the Credit Commission, Sofia.

Ministry of Agriculture and Forestry (2000),
Annual Report, 2000.

OECD (2000),
AGR/CA/APM(2000)15.

Roussenova, Lena (2001),
"The Bulgarian Currency Board: Specifics, Experience, and Possible Challenges", paper presented at a London Business School conference, London, March 2001.

Swiss Co-operation in Bulgaria (2000),
An Issue of the Co-ordination Office of Swiss Embassy, Sofia.

Swiss Foundation for Sustainable Development in Bulgaria,
Internal Procedures, Conditions and Criteria for Approval of Loan Applications by Private Farmers, Sofia.

Ulgenerk, Esen and L. Zlaoui (2000),
"From Transition to Accession", *World Bank Technical Paper* # 473.

World Bank (2001),
Bulgaria. The Dual Challenge of Transition and Accession, A World Bank Country Study, February 2001.